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**IN THE UNITED STATES BANKRUPTCY COURT**
**FOR THE DISTRICT OF UTAH, CENTRAL DIVISION**

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| In re: | |
| CASTLE ARCH REAL ESTATE INVESTMENT COMPANY, LLC; CAOP MANAGERS, LLC; CASTLE ARCH OPPORTUNITY PARTNERS I, LLC; CASTLE ARCH OPPORTUNITY PARTNERS II, LLC; CASTLE ARCH KINGMAN, LLC; CASTLE ARCH SECURED DEVELOPMENT FUND, LLC; and CASTLE ARCH SMYRNA, LLC, | Bankruptcy Case No. 11-35082<br>Bankruptcy Case No. 11-35237<br>Bankruptcy Case No. 11-35240<br>Bankruptcy Case No. 11-35242<br>Bankruptcy Case No. 11-35243<br>Bankruptcy Case No. 11-35246<br>Bankruptcy Case No. 11-35241<br><br>(Jointly Administered)<br>(Chapter 11) |
| Debtors. | Honorable Joel T. Marker |

**MOTION FOR APPOINTMENT OF A CHAPTER 11 TRUSTEE IN THE CASTLE ARCH SECURED DEVELOPMENT FUND, LLC, CASE AND MEMORANDUM IN SUPPORT**

Richard Dance, 1031 ECI LLC, Vince Amata, Kenneth Gneuhs, Bill Grundy, Naomi King Trust, Daniel Maga, Pearl Noreen, Fran Pistorio, Ray Rosato, and Ziba Sabour (collectively

**"Preferred Investors"**), holders of Preferred Units[1] in Castle Arch Secured Development Fund, LLC (**"CASDF"**), by and through their counsel, Anna W. Drake, move this Court for an order appointing a Chapter 11 Trustee in *In re Castle Arch Secured Development Fund, LLC,* Bankruptcy No. 11-35246 (**"CASDF Case"**) pursuant to 11 U.S.C. § 1104(a)(2)[2]. In support of this motion, the Preferred Investors respectfully represent as follows:

## INTRODUCTION

1. CASDF filed a voluntary petition for relief under Chapter 11 of the Code on October 20, 2011. CAREIC[3] and the other jointly-administered Debtors filed their cases on either October 17 or October 20, 2011.

2. Following a motion filed by the Official Committee of Unsecured Creditors (**"Committee"**) for CAREIC for the appointment of a Chapter 11 trustee in the CAREIC case or conversion of that case to a Chapter 7 case, this Court appointed D. Ray Strong as Chapter 11 Trustee (**"Trustee"**) of CAREIC on May 3, 2012.

3. The Trustee is acting as manager either directly or indirectly for each of the jointly-administered Debtors.

4. On September 29, 2012, the Trustee filed his *CHAPTER 11 TRUSTEE'S PLAN OF LIQUIDATION DATED SEPTEMBER 29, 2012* (**"Plan"**), together with an accompanying disclosure

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[1]These Preferred Investors hold no less than 1,650,079 units of the total 7,303,417 Preferred Units in CASDF (22.59%).

[2]All further references to 11 U.S.C. § 101 *et. seq.* shall be shown as "§ ___."

[3]All capitalized terms herein shall correspond to defined terms in the Plan, unless otherwise indicated.

statement (**"Disclosure Statement"**) proposing his plan for the orderly liquidation of assets or reorganization of the Debtors.

5. The Plan as summarized in the Disclosure Statement purports to be very simple: consolidate the Legacy Debtors and then treat those Legacy Debtors all equally – without the ability of the individual Preferred Investors to vote on such consolidation in the CASDF case.

6. On November 26, 2012, the Preferred Investors filed an *OBJECTION TO ADEQUACY OF DISCLOSURE STATEMENT FOR CHAPTER 11 TRUSTEE'S PLAN OF LIQUIDATION DATED SEPTEMBER 29, 2012* (**"Objection"**). The bases for the Objection included (a) lack of an analysis of the effects of consolidation versus non-consolidation; (b) lack of documentation necessary to determine how Creditors and Interest Holders will be paid; (c) failure to disclose the amount of pending and future administrative expenses; (d) lack of a liquidation analysis; and (e) general lack of sufficient information to assist the Preferred Investors in determining whether to vote for or against the proposed Plan.

7. In addition to the issues raised by the Preferred Investors in the Objection relating to lack of information, the Objection also set forth issues relating to the confirmability of the Plan.

## ARGUMENT
## THE CASDF CASE NEEDS AN INDEPENDENT TRUSTEE

Section 1104(a)(2) provides:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee –

> (2) *if such appointment is in the interests of* creditors, *any equity security holders*, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor. [emphasis added]

The Preferred Investors allege that the conflicts which exist between CAREIC and the other Debtors (specifically CASDF, CAOP I and CAK) *require* the appointment of an independent trustee. In fact, one of the reasons for the appointment of the Trustee in CAREIC was the existence of intercompany transfers. It is true that each of the Debtors has separate counsel; however, the Trustee is acting as the manager of each of the Debtors and thereby controlling each Debtor. For the same reasons that each Debtor has independent counsel, each Debtor should have an independent trustee. For purposes of this Motion, the Preferred Investors are seeking an independent trustee only for CASDF.

**A. THERE ARE NUMEROUS CONFLICTS OF INTERESTS BETWEEN THE DEBTORS.**

(1) **General Intercompany Claims**. A review of the Schedules filed in each of the Debtors' Cases reflects that there are substantial intercompany claims. Through consolidation, the Trustee seeks to wipe out all of these intercompany claims. The Trustee has not disclosed that one of the major reasons for his efforts to obtain consolidation is that he has a major conflict of interest in pursing these claims. Rather than dealing "head on" with this issue, he simply wipes the slate clean through consolidation. If these cases (other than CAREIC) were still being run as independent cases with separate counsel, those counsel could advise each respective Debtor regarding its claims and defenses regarding secured and unsecured loans between the companies, as

well as the effect of possible avoidance actions. With the Trustee controlling each Debtor, however, the rights of creditors and interest holders in each case are being compromised.

No intercompany claims have yet been filed by any of the Debtors, and the bar date for doing so has been extended. It does not appear that the Trustee intends to instruct any of the Debtors to file such intercompany claims. If those claims are not timely filed, significant rights may be lost by creditors and the Preferred Investors.

(2) **CAREIC Guaranty of Kingman Debt**. On page 16 of the Disclosure Statement, the Trustee indicates that CASDF "asserts it obtained Liens from CAK, and a guarantee of approximately $10 million in debt from CAREIC." The Preferred Investors agree that CASDF obtained Liens on property owned by CAREIC and/or CAK to secure a claim in the sum of approximately $11,300,000; they further assert that CAREIC guaranteed $10,000,000 of that debt. The Trustee then states: "Based on his investigation to date, the Trustee has determined that the Liens and the guarantee are likely unenforceable because, in many instances, CAK did not hold title to purported Collateral, and CAREIC's guarantee was not the subject of any written agreement." There is no further disclosure regarding this issue.

The Trustee fails to disclose that (a) CAREIC approved a written resolution as of February 1, 2008, providing for the guarantee of up to Ten Million Dollars; (b) the resolution was in the best interests of CAREIC "because it will increase the Fund's ability

to attract and maintain capital which in turn can increase value to the Company;" (c) the Notes to the Consolidated Financial Statements dated December 31, 2008, disclosed the existence of the resolution and the guarantee; and (d) the "Confidential Private Offering Memorandum for Accredited Investors Only - Castle Arch Secured Development Fund, L.L,C." stated:

> **Security.** The Fund intends to invest in projects collateralized by a senior lien on the real property that is the subject of the investment. Additionally, CAREIC will further back the Fund investor's investment and interest. These measures will increase the Fund's ability to deliver highly favorable returns on its invested capital to its investors. Notwithstanding the foregoing, the preferred units sold in this offering are not guaranteed or secured, nor is the Fund, its investors or investments insured or guaranteed by any government agency.

These disclosures by the Trustee clearly show that the Trustee has a significant conflict of interest in ascertaining the validity of the Lien in favor of CAK and the enforceability of the $10,000,000 guarantee (both of which would benefit the Preferred Investors).

(3) **Avoidance Actions should be Pursued**. The Schedules filed in the CAOP I Case reflect the ownership of "348.2 acres of RR-5 zoned raw land and water rights in Tooele, Utah" (the **"Tooele Property"**) valued at $5,360,000.00. Within one year of the Petition Date, CAREIC caused the Tooele Property to be transferred to CAOP I (the **"Tooele Property Transfer"**). The Trustee states on page 11 of the Disclosure Statement: "CAREIC has Claims and Causes of Action, including Avoidance Actions,

related to the Tooele Property Transfer against CAOP I, but at this time the viability of those Claims and Actions is not certain."

Under the Trustee's Plan, he intends to have a Conflicts Referee sort out this issue. The value of this transfer exceeds $5 million dollars – this is arguably one of the largest potential assets of CAREIC, but the Trustee is not pursuing it at this time. The Preferred Investors believe that this asset should be pursued by the Trustee immediately since CASDF has a $10,000,000 claim against CAREIC (as described above).

(4) **The Appointment of a "Conflicts Referee" does not Solve the Trustee's Conflicts of Interests and Occurs after Consolidation**.

The Trustee attempts to acknowledge that he may have conflicts of interest based upon the provision for the appointment of a "Conflicts Referee." The problem with this provision, however, is that most, if not all, of the conflicts that presently exist will be extinguished through the consolidation. Evidence must be presented showing that the Trustee has the right to simply ignore all intercompany claims and possible avoidance actions.

The Tenth Circuit Court of Appeals considered the issue of conflicts of interest by counsel in related cases in *Interwest Business Equipment, Inc., v. United States Trustee (In re Interwest Business Equipment, Inc., et al.,* 23 F.3d 311 (1994). In that case, the Tenth Circuit analyzed the "reasons why counsel to a debtor in possession must meet the high standards of un divided loyalty established in § 327" by quoting from the memorable passage in *In re McKinney Ranch Assoc.,* 62 B.R. 249 (Bankr.C.D.Cal. 1986):

> It is the duty of counsel for the debtor in possession to survey the landscape in search of property of the estate, defenses to claims, preferential transfers, fraudulent conveyances and other causes of action that may yield a recovery to the estate. The jaundiced eye and scowling mien that counsel for the debtor is required to cast upon everyone in sight will likely not fall upon the party with whom he has a potential conflict . . ..

*Id.* at 254. The Tenth Circuit thereby upheld the Bankruptcy Court's finding that

> The existence of a prepetition debt *from one estate to the other* creates a disqualifying conflict of interest. These interlocking interests can only be served by utilizing separate counsel who can fairly and fully advise each debtor as to its rights and responsibilities.

The Debtors in these cases have separate, independent legal counsel appointed for each of them; however, these attorneys are receiving all direction from the Trustee as the managing member of each entity. This arrangement does *not* provide the protections for the creditors of each estate as contemplated by the Court in *Interwest* and *McKinney*.

**B. THE TRUSTEE'S PROPOSED CONSOLIDATION IS NOT IN THE BEST INTERESTS OF THE PREFERRED INVESTORS.**

Paragraphs C(1) and C(2) of Article IV of the Disclosure Statement provide for the substantive consolidation of CAREIC, CAK, CAOP Managers, CAS, CASDF and CASV (Star Valley) to be named the "Legacy Debtors." Excluded from this definition are CAOP I and CAOP II. This consolidation is to be "for all purposes under the Plan, including for purposes of voting on the Plan, allowance of Claims or Equity Interests and Distribution through the Plan and, as applicable, the Legacy Trust."

Although the Trustee does outline the factors enumerated in *Fist v. East,* 114. 4.2d 177 (10th Cir. 1940), his analysis contains summaries of his conclusions regarding each of those factors, rather than disclosing the actual facts and numbers supporting those conclusions. For example, the Trustee makes the following statement:

> The Legacy Debtors were operated as a single enterprise, with none of the Legacy Subsidiaries having separate management or an existence outside of CAREIC and the corporate family. As discussed above in Part II, Section (B)(4), management used separate bank accounts of the Legacy Debtors as "piggy banks" for the others, transferring Cash from the accounts to whichever Entity was in need of Cash at the time. In fact, *the Trustee has determined that given the Legacy Debtors' use of Cash and the volume and complexity of intercompany transfers and intercompany Claims involved, attempting to treat the Legacy Debtors as separate Entities would be extremely difficult and, if possible, prohibitively expensive. It also would serve little purpose as any resulting benefit obtained by any one Legacy Debtor would be consumed by the expense and delay involved in achieving that benefit.* [Disclosure Statement at pp. 37 - 38; emphasis added.]

This statement contains a number of conclusions which are meaningless without the supporting information. Substantial information needs to be provided to all parties, including the benefits and burdens upon all parties, as the result of a possible consolidation. It is not enough that the Trustee simply believes that it is too complicated or too expensive to discuss.

Another issue is raised by the Trustee's conclusion that the CAOP Debtors should *not* be included in the consolidation. There appear to be significant assets in these entities, yet the Trustee gives *no* basis whatsoever for why these entities should not be part of the consolidation.

(1) **Consolidation Must be Considered on a Case-by-Case Basis after Notice and a Presentation of All Relevant Evidence**.

The Trustee is acting as the manager of each of the Debtors herein. He has made the decision that the Cases should be consolidated for all purposes. Normally, consolidation would be achieved prior to confirmation after notice and a hearing. The Trustee is effectively attempting to bootstrap consolidation upon all creditors and parties in interest without the necessity of actually setting forth any concrete information why these cases should be consolidated. The consolidation should be treated as a separate and distinct matter from confirmation.

In order to achieve his intended result, the Trustee has provided that no creditors or interest holders will be voting in their individual Cases, but rather to the extent that creditors or interest holders vote, their votes will be counted in the [already] consolidated Legacy Case. The Trustee provides no authority for his right to force this consolidation upon each of the Debtors.

The Trustee states (*see* Disclosure Statement at p. 40): "The Trustee thus has proposed consolidation of the Legacy Debtors because recognizing corporate formalities in this setting *would be unfair and not promote equitable distributions of assets to holders of Allowed Claims and Allowed Equity Interests*." [emphasis added]. There is no discussion in the Disclosure Statement why failing to consolidate would be "unfair" or "not promote equitable distribution" – in fact, the Preferred Investors believe that consolidation will have negative effect upon CASDF Preferred Investors (specifically

relating to the $10,000,000 guaranty and security for the Kingman loan referenced *above*).

The remedy of substantive consolidation was not specifically provided for in the Bankruptcy Act of 1898 – rather, a court's ability to order substantive consolidation was implied from the bankruptcy court's general equitable powers ("courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.") (*see Reider v. Federal Deposit Insurance Corp.,* 31 F.3d 1102, 1105 (11th Cir. 1994) (citing *Pepper v. Litton,* 308 U.S. 295, 304 (1939). While substantive consolidation was not codified in the Bankruptcy Reform Acts of 1978 and 1994, it is now allowed under the court's broad equitable powers detailed in § 105(a): "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

The Tenth Circuit has ruled that substantive consolidation may be employed under appropriate circumstances which are set forth in *Federal Deposit Ins. Corp. v. Hogan (In re Gulfco Invest. Corp.),* 593 F.2d 291 (10th 1979). One of those factors consists of the extent to which one corporation "is a mere instrumentality or alter ego of the bankrupt corporation, with no independent existence of its own." *Gulfco,* 593 F.2d at 928. CASDF was a separate entity. The investors holding Preferred Interests invested $7,303,417 into CASDF – not into CAREIC. They believed that their investments were to be secured by a lien in favor of CAK and a $10,000,000 guarantee. The Preferred

Investors believe that substantive consolidation will be extremely detrimental to their interests if the Lien is allowed and the guarantee acknowledged. The Trustee must *prove* that all of the entities were alter egos, on a case-by-case basis.

*Gulfco* also requires that the assets of the entities be "hopelessly commingled." *Id.* at 929. The Trustee concludes that all assets are hopelessly commingled. Not a shred of actual evidence has been presented to support this assertion.

In 2007, Judge Thurman ruled that "substantive consolidation should be used sparingly because it is a tool 'vitally affecting substantive rights.'" *See In re George Love Farming, LC,* 366 B.R. 170, 180 (Bankr. Ut. 2007). The Preferred Investors herein submit that treating the Legacy Debtors as consolidated entities is not warranted and that their rights will be "vitally affected" – in a detrimental way. Furthermore, consolidation without including the CAOP Debtors adds further damage to the Preferred Investors.

The Preferred Investors assert that the Trustee's attempt to force consolidation upon all Debtors through the Plan is a symptom of his conflict of interest and is evidence that a Trustee should be appointed in the CASDF Case.

(2) **Requiring all Voting to Occur in the Legacy Debtors Cases Violates § 1129.**

The Trustee takes all Secured Creditors of the "Legacy Debtors" and places them in one Class. He also places all Unsecured Creditors of those Debtors into one class, and takes all Interest Holders and places them in one Class. These provisions do not comply

with Sections 1129(a)(7), (8), and (9), nor do they meet the requirements of §§ 1129(b)(1) and (2).

An independent trustee needs to be appointed in the CASDF Case to determine whether this provision is in the best interests of the creditors and interest holders (including the Preferred Investors) in the CASDF Case.

(3) **Extinguishment of Loan Obligations between CAREIC, CAK and CASDF**.

As discussed *above* in connection with the Kingman loan made by the Preferred Investors in the CASDF Case, the Trustee intends to ignore the Lien in favor of CAK and ignore the $10,000,000 guarantee (both of which would benefit said investors). These provisions do not comply with §§ 1129(a)(7), (8), and (9), nor do they meet the requirements of §§ 1129(b)(1) and (2).

An independent trustee for the CASDF Case should be appointed to review these transactions.

## CONCLUSION

The appointment of the Trustee in the CAREIC Case has resulted in conflicts of interest between the jointly-administered Debtors because the Trustee is now controlling each of the Debtors and those Debtors (despite the existence of separate counsel for each debtor-in-possession) are not acting independently from the Trustee.

The resulting conflicts of interest between the CAREIC, CAOP I, CAK and CASDF Cases are not being resolved by the present Trustee. Under the Trustee's Plan, all claims

between CAREIC, CAK and CASDF will simply be extinguished by the consolidation of those cases into the Legacy Debtors. The conflict of interest regarding CAOP I will be resolved by the Conflicts Referee. In addition, these actions are being proposed by the Trustee without disclosure of the amounts, strengths, and weaknesses of the intercompany claims and avoidance actions.

These solutions are *not* in the best interests of the Preferred Investors since their interests may be substantially diluted. Only a completely independent Trustee has the ability to assess these issues and act independently in the best interests of the CASDF creditors and Preferred Investors.

In the event that this Court does not appoint a trustee for the CASDF Case, there are sufficient factors to support conversion under § 1112(b)(4) and this Court *shall* convert the CASDF Case to Chapter 7.

WHEREFORE, the Preferred Investors pray that this Court appoint an independent trustee in the CASDF Case, and that they have such other and further relief as is just.

RESPECTFULLY SUBMITTED this 2nd day of December, 2012.

*/s/ Anna W. Drake*

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CERTIFICATE OF SERVICE

I hereby certify that I served a copy of the foregoing Objection via ECF or US Mail

December 2, 2012on December 2, 2012, as follows:

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